

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: LM:CTM:SEA:TL-N-6786-00
GMHahn

date: **MAR 30 2001**

to: Carol Mitchell
IRS Team Coordinator (LMSB)
Boise, Idaho

from: Greg Hahn, IRS Counsel, LMSB Area 5, Seattle

subject: [REDACTED] Section 382 Issue

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ISSUES

- I. Did [REDACTED] properly value, for section 382(e) purposes, the [REDACTED] shares of [REDACTED] common stock issued to the [REDACTED] creditors pursuant to the merger of [REDACTED] and [REDACTED]? Did [REDACTED] properly value, for purposes of computing the I.R.C. § 108(b)(2) income from discharge of indebtedness and the corresponding reduction in tax attributes, the [REDACTED] common stock and the [REDACTED] stock distributed to the [REDACTED] creditors?
- II. Should the value of the loss corporation under section 382(e) include the value of the [REDACTED] preferred shares issued to certain [REDACTED] creditors pursuant to the merger of [REDACTED] and [REDACTED]?

RELEVANT FACTS

In [REDACTED], a Delaware Corporation, began experiencing significant losses and negative cash flow problem. [REDACTED] financed this negative operating cash flow by significantly increasing its debt load. In early [REDACTED], [REDACTED] determined that it could not meet its debt obligations coming due in [REDACTED] and concluded that the restructuring alternative best designed to maximize the recovery for all stakeholders was through a prepackaged Chapter 11 filing¹ which included the merger of [REDACTED] into [REDACTED]. To effectuate a pre-packaged Chapter 11 filing, [REDACTED] conducted intensive negotiations with various creditors in an effort to restructure its indebtedness. These negotiations resulted in the initial merger agreement, which was finalized and announced on [REDACTED].

On [REDACTED], [REDACTED] filed a Chapter 11 petition with the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court"). The merger was an integral part of the pre-packaged Chapter 11 bankruptcy plan of reorganization (the "Plan"). On [REDACTED], a "[REDACTED]" was filed with the Bankruptcy Court. The Plan was confirmed by the Bankruptcy Court on [REDACTED] and became effective concurrent with the merger on [REDACTED] (the "Effective Date").

On [REDACTED], [REDACTED] merged with and into [REDACTED] with [REDACTED] being the surviving corporation in the merger. Following the merger, [REDACTED] was renamed [REDACTED]. The merger was treated as a tax-free "A" reorganization.

On the Effective Date, [REDACTED] acquired [REDACTED]'s net assets, substantially all of [REDACTED]'s senior debt obligations were discharged, and all of [REDACTED]'s outstanding common stock was canceled. In exchange therefor, [REDACTED]'s creditors received the following distributions under the Plan: (1) \$[REDACTED] in cash; (2) \$[REDACTED] from a promissory note owed to [REDACTED] by [REDACTED]; (3)

¹In a prepackaged Chapter 11 bankruptcy filing, the debtors and creditors meet prior to the filing of a petition with the bankruptcy court to work out the terms of the debt restructure plan. Once the terms are agreed, a Petition is filed along with the agreed plan. This differs from a traditional filing where the terms of the restructure are not discussed until after the Petition is filed. Once the Petition is filed, the restructure plan must be approved by the creditors, the equity holders and the court. The benefit of the prepackaged plan is that the debt restructure plan is generally approved without any problems as the plan has been negotiated prior to the filing of the Petition.

_____ shares of _____ common stock; (4) _____ shares of newly issued _____ common stock; and (5) _____ newly issued shares of _____ preferred stock. _____ accounted for the merger under the purchase method of accounting (_____. _____ reported the _____ purchase price as \$ _____.

The purchase price and total consideration paid to _____'s creditors was computed as follows:

	<u>Shares</u>	<u>Unit Price</u>	<u>Purchase Price-Books</u>	<u>Paid to Creditors</u>
Cash			\$ _____	\$ _____
_____ C/S ²	_____	\$ _____	_____	_____
_____ warrants ³	_____		_____	_____
_____ P/S	_____		_____	_____
Acq. costs			_____	_____
_____ Note				_____
_____ Stock	_____			_____
Total			\$ _____	\$ _____

On _____ issued _____ shares of _____ Series A Preferred Stock ("Preferred Stock") into a liquidating

²On _____ amended its Certificate of Incorporation to (a) increased the total authorized shares of _____'s common stock from _____ to _____, and (b) increased the total authorized shares of _____'s preferred stock from _____ to _____. As of _____ shares of _____ common stock were outstanding, which included the _____ shares newly issued in connection with the merger. The number of newly issued shares represented _____ of the shares outstanding after the merger, as required by the Plan.

³The warrants allowed the holders to purchase shares of _____ stock at \$ _____ per share, exercisable for a term of _____ years.

⁴This information agrees with the information reported in the _____'s _____ 10-K. According to _____ the purchase price was allocated to the assets acquired and liabilities assumed based on estimated fair values at _____ as follows:

Net Working Capital	\$ _____
Investments and other assets	_____
Costs in excess of net assets acquired	_____
Property and equipment	_____
Non-current liabilities	_____
Purchase Price	\$ _____

trust to be held for the benefits of [REDACTED]'s creditors^{5,6}. Redemptions of the Preferred Stock was scheduled to be made from a "Sinking Fund" into which [REDACTED] was required to deposit any federal income tax refunds (and interest) received by [REDACTED] arising from amended federal income tax returns of [REDACTED] and consolidated subsidiaries for the years [REDACTED] through [REDACTED]. The amended returns were filed to change [REDACTED]'s election from deducting foreign taxes to claiming a credit for those taxes ("FTC Refunds"). The amended returns were filed prior to [REDACTED]. The cumulative maximum amount of FTC Refunds to be deposited in the Sinking Fund was \$ [REDACTED].

Under the Plan, if Preferred Stock was not redeemed and canceled through the distribution of \$ [REDACTED] within [REDACTED] years of the issuance of the Preferred Stock, [REDACTED] was required to redeem all shares of the Preferred Stock at a per share redemption price equal to the greater of \$ [REDACTED]⁷ or a pro rata portion of any undistributed amounts of the FTC Refunds. Similarly, upon the liquidation, dissolution or winding up of the affairs of [REDACTED], the holders of the Preferred Stock were entitled to receive, before an amount is paid or distributed to any holders of common stock, a per share amount equal to the greater of \$ [REDACTED] or a pro rata share of any undistributed amounts of such refunds.

Under the Plan, holders of the Preferred Stock are entitled to vote together with holders of common stock as a single class on all matters with respect to which the holders of common stock are

⁵According to the [REDACTED], the Preferred Stock was issued for the benefit of [REDACTED]. [REDACTED] creditors consists of the unsecured funded debt claims, unsecured [REDACTED] claims, unsecured [REDACTED] claims, [REDACTED] claims and [REDACTED] claims. The amounts of the pre-merger claims of these creditors is unknown, as is their percentage of recovery.

⁶This following Preferred Stock information was obtained from [REDACTED] of [REDACTED]'s [REDACTED] 10-K. The information agreed with the Preferred Stock information contained in [REDACTED] the "[REDACTED]" which document was attached as [REDACTED] to the [REDACTED] filed by [REDACTED] on [REDACTED].

⁷[REDACTED]
[REDACTED] states that the redemption price would be \$ [REDACTED] per share, not \$ [REDACTED] per share. It appears that this discrepancy arises from the fact that the [REDACTED] states that the number of shares to be issued is [REDACTED] rather than [REDACTED].

entitled to vote. Each share of Preferred Stock has [REDACTED] of a vote⁸. The Preferred Stock holders are not entitled to receive dividends.

On [REDACTED] of the [REDACTED], the following risk associated with the Preferred Stock were disclosed:

[REDACTED]

In [REDACTED] of [REDACTED]'s [REDACTED] 10-K, [REDACTED] reported the following information regarding the status of the FTC Refund:

[REDACTED]

The \$ [REDACTED] in FTC Refunds was received in [REDACTED] and the Preferred Stock was redeemed for \$ [REDACTED] on [REDACTED]. Following the redemption, all Preferred Stock shares were canceled and all rights of the holders were terminated.

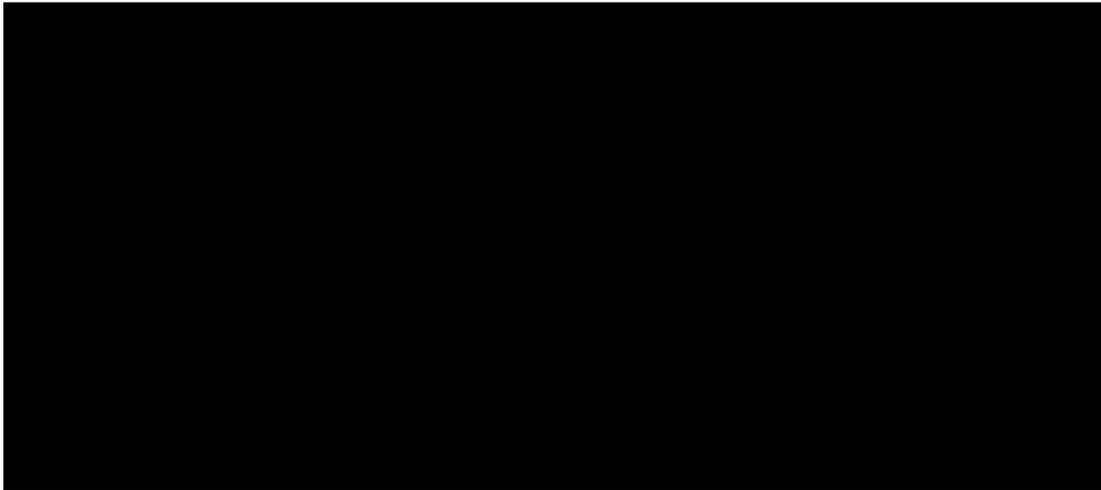
⁸ [REDACTED]
[REDACTED] states that each share is entitled to [REDACTED] of a vote, not [REDACTED] of a vote. It appears that this discrepancy arises from the fact that the [REDACTED] states that the number of shares to be issued is [REDACTED] rather than [REDACTED].

On its first federal income tax return filed after the merger, [redacted] reported its annual Section 382 Limitation as \$ [redacted]. This amount was computed as follows:

	Shares	Price	Total
Common Stock	[redacted]	[redacted]	\$ [redacted]
Cash	[redacted]		[redacted]
Preferred Stock	[redacted]		[redacted]
Total \$ 382(e) Value			\$ [redacted]
Tax Exempt Rate, [redacted]			[redacted] %
Annual \$ 382 Limitation			\$ [redacted]

In computing its I.R.C. \$ 382(e) value, [redacted] valued the [redacted] common stock at \$ [redacted] per shares rather than the \$ [redacted] per share price used for book purposes (GAAP) or the \$ [redacted]¹⁰ price quoted on

[redacted]⁹ reported in its unaudited 10-Q for the quarter ending [redacted] that the \$ [redacted] unit price for the [redacted] common stock was an estimate which may differ materially from market price:



The [redacted] 10-Ks filed for FYE [redacted] and [redacted] did not contain similar disclaimers with respect to the stock value.

¹⁰ [redacted] of the [redacted] estimates the total purchase price of the merger to be \$ [redacted] assuming the merger was effective on [redacted]. This estimate was based on a [redacted] common stock value of \$ [redacted] or \$ [redacted] per share. The following disclaimer was included with respect to the \$ [redacted] per share amount used to value the common stock:



estimate of market value of such securities as of the Effective Date or any other date. [REDACTED] further stated that the purpose of the discounts "[REDACTED] originally agreed by the parties and was not intended by the parties to reflect the fair market value of the company on the date [REDACTED]"

[REDACTED] was asked in IDR 15 to explain how the \$ [REDACTED] share was determined and whether the amount was discounted by any amount, including the [REDACTED]% discount which was to be used in any "Initial Equity Recovery" computation¹³. In its response to IDR 15, [REDACTED] indicated that the per share value was discounted to reflect the approximate value of the [REDACTED] common stock as of the date the bankruptcy restructuring deal was originally negotiated (i.e., [REDACTED]). [REDACTED] was unable to locate any documentation to support the computation of the discount.

With respect to the GAAP/tax differences in the [REDACTED] stock prices, [REDACTED] indicated in IDR 15 that the stock prices used for book purposes do not reflect fair market value as the merger date of [REDACTED]. Rather, the book prices were computed in conformity with APB 16 which "provides guidance and suggestions as to the value that should be reported for financial reporting purposes and does not purport to establish fair market value of a transaction for tax purposes." [REDACTED] claims that the appropriate price to use for tax purposes is the trading price on the merger date, which is the \$ [REDACTED] per share price used by [REDACTED] in the section 382(e) computation¹⁴.

¹³ [REDACTED] discusses the computation to be used in the event that there is an "Initial Equity Recovery" ("IER"). An IER will occur if, on the Effective Date, the "Total Plan Value exceeds Maximum Potential Total Creditor Claims." If there is an IER, certain creditors will receive additional shares of [REDACTED] stock. For purposes of computing the IER, the term "Total Plan Value" includes the "assumed value" of the [REDACTED] common stock to be distributed under the Plan. The "assumed value" of the [REDACTED] stock equals (1) the number of [REDACTED] stock to be issued x (2) the "weighted average stock price" x (3) [REDACTED]%. The "weighted average stock price" equals the weighted average closing price for [REDACTED] stock on the [REDACTED] during the period of [REDACTED] consecutive trading days ending on the [REDACTED]th day following the Confirmation Date.

¹⁴ [REDACTED] states that under APB 16, the stock price to value the transaction should be the "market price for a reasonable period before and after the date the terms of the acquisition are agreed to and announced." In addition, [REDACTED] indicates that APB 16

LEGAL DISCUSSION

If there is an ownership change of a corporation with a net operating loss, I.R.C. § 381¹⁵ permits the corporate taxpayer to preserve the net operating loss after the "ownership change." However, section 382 limits the amount of the annual NOL deduction. Section 382 reflects the long-standing congressional perception that trafficking in loss carryovers must be regulated to prevent abuse. Berry Petroleum Co. v. Commissioner, 104 T.C. 584, 632 (1995)

Section 382 was enacted to regulate an "ownership change" involving a "loss corporation"¹⁶. The key to the operation of section 382 is the statutory "ownership change," which term is defined in section 382(g)(1). If there has been an "ownership change," the new loss corporation can only deduct its pre-change losses against an amount of income equal to the "Section 382 Limitation". I.R.C. § 382(a). The "Section 382 Limitation" is defined as the value of the old loss corporation multiplied by the

states that using a value different from the quoted market value may be appropriate where "the number of shares issued is large, trading in a security is thin, a stock's price is volatile, or other uncertainties exists." In the case at hand, the merger was agreed to on [REDACTED] but not finalized until [REDACTED]. [REDACTED] suggests in its response that the value used for book purposes is consistent with the average stock trading price at the time the transaction was announced on [REDACTED] (but does not provide any documentation to support this computation). [REDACTED] states that while this valuation date may be appropriate for GAAP purposes, this is not the appropriate valuation date for tax purposes.

¹⁵Section 381(a) allows a corporate taxpayer to pass certain tax attributes to "another corporation." Section 381(c)(1) specifically identifies the section 172 net operating losses as a tax attribute that is included under section 381(a).

¹⁶The term "loss corporation" means a corporation with a net operating loss carryover or a net operation loss for the taxable year in which there is an "ownership change". I.R.C. § 382(k)(1). The term "old loss corporation" means a loss corporation before the ownership change, I.R.C. § 382(k)(2), the term "new loss corporation" means a loss corporation after the ownership change, I.R.C. § 382(k)(3). The same corporation may be the old loss corporation and the new loss corporation. Id.

long-term tax-exempt rate¹⁷. I.R.C. § 382(b)(1). The value of the "old loss corporation" is determined pursuant to I.R.C. § 382(e).

The Section 382 Limitation will not apply to an ownership change if (1) the loss corporation is under the jurisdiction of a court in a Title 11 bankruptcy or similar case immediately before the ownership change and (2) the shareholders and creditors of the loss corporation (determined immediately before the ownership change) own (after the ownership change) at least 50% of the total voting power of the stock of the corporation as well as at least 50% of the total value of the stock of the corporation¹⁸. I.R.C. § 382(1)(5)(A). A loss corporation that qualifies for section 382(1)(5) treatment can use its NOL carryforwards, after certain reductions, against its post-change income without limitation by section 382(a).

Where an insolvent corporation doesn't qualify for section 382(1)(5) treatment¹⁹, I.R.C. § 382(1)(6) provides special valuation rules for these ownership changes. Under the special valuation rule of section 382(1)(6), the value of the loss corporation is equal to the lesser of the value of its stock ("stock value test") immediately after the ownership change, Treas. Reg. § 1.382-9(j)(1), or the value of its assets ("asset value

¹⁷The Section 382 Limitation is intended to approximate the annual income that the business capital of the old loss corporation would have generated, and thereby prevent the new loss corporation from using the loss carryovers faster than the old loss corporation could have used them in the absence of a change in ownership. Berry Petroleum, 104 T.C. at 633.

¹⁸Generally, to qualify for the rule, stock transferred to a creditor is taken into account (1) only to the extent that the stock is transferred in satisfaction of indebtedness and (2) only if the indebtedness was held by the creditor at least 18 months before the filing of the insolvency proceeding or whose claim arose in the ordinary course of business. I.R.C. § 382(1)(5)(E).

¹⁹An insolvent loss corporation may not qualify for section 382(1)(5) treatment if, for example, the loss corporation cannot satisfy the requirement that the former shareholders and creditors own 50% of the new loss corporation's stock. Likewise, an insolvent loss corporation may "elect out" from this treatment pursuant to I.R.C. § 382(1)(5)(H). An insolvent loss corporation may find the section 382(1)(6) valuation rules more advantageous since these rules include in the section 382(e) computation the increase in value of the loss corporation that results from the surrender or cancellation of the creditor's claims.

test"), determined without regards to liabilities, immediately before the ownership change, Treas. Reg. §§ 1.382-9(j)(2), (l)(1).

██████████ appears to have computed its Section 382 Limitation using the stock value test rather than the asset value test. As no information was presented with respect to the value of the loss corporation computed under the asset value test, Counsel's analysis will focus exclusively on the stock value test. For purposes of the advice rendered in this memorandum, Counsel has assumed that ██████████ has complied with all the other statutory requirements of Section 382, that the only issue in dispute for Section 382 purposes is the proper valuation of the loss corporation under I.R.C. § 382(e). With respect to the stock value test, Counsel has assumed that the value of the loss corporation under the stock value test is less than the value computed under the asset value test. Please advise Counsel immediately if these assumptions are incorrect.

I. FOR PURPOSES OF COMPUTING THE VALUE OF THE LOSS CORPORATION UNDER SECTION 382(e), THE ██████████ COMMON STOCK SHOULD BE VALUED USING THE TRADING PRICE ON THE EFFECTIVE DATE OF THE MERGER.

In computing its Section 382 Limitation, ██████████ valued the ██████████ shares of ██████████ common stock issued to the ██████████ creditors at \$██████████ per share, for a total value of \$██████████. As summarized above, ██████████ used a lower valuation of this stock (\$██████████ per share and \$██████████ per share) for GAAP purposes and in its ██████████. Counsel's advice has been requested on whether the lower values should also be used for computing ██████████'s Section 382 Limitation.

The calculation of the Section 382 Limitation starts with "the value of the old loss corporation." I.R.C. § 382(b)(1)(A). For stock that meets the qualifications of section 382(l)(6), the section 382(e) value is computed based on the fair market value of the stock immediately after the ownership change. I.R.C. §§ 382(e), (k)(5), (l)(6); Treas. Reg. § 1.382-9(j)(1). For purposes of this advice, Counsel has assumed that the ██████████ shares of ██████████ common stock is properly included in the section 382(e) valuation pursuant to section 382(l)(6). Please advise Counsel if this assumption is incorrect.

The fair market value of a stock is the price at which it "would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Berry Petroleum, 104 T.C. at 637, citing United States v. Cartwright, 411 U.S. 546, 551 (1973) (a test "nearly as old as the federal income, estate, and gift taxes themselves"); Morris v. Commissioner, 70 T.C. 959,

988 (1978). If a stock is publicly traded on an established market, the best evidence of the value of stock is its trading price. L.B. Maytag v. Commissioner, 187 F.2d 962 (10th Cir. 1951); Estate of Gilford v. Commissioner, 88 T.C. 38 (1987); Dellacroce v. Commissioner, 83 T.C. 269, 288 (1984); Danon v. Commissioner, 49 T.C. 108 (1967); Estate of Spencer v. Commissioner, 5 T.C. 904 (1945), acq., 1946-1 C.B. 4; Staley v. Commissioner, 41 B.T.A. 752 (1940); Blumenthal v. Commissioner, 21 B.T.A. 901 (1930); Rev. Rul. 59-60, 1959-1 C.B. 237 ("As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented"). Where public markets exist for stock, the market should be considered to have assimilated all available information concerning the company. Estate of Gilford v. Commissioner, 88 T.C. 38, 55 (1987). However, prices obtained at forced sales, at public auctions, or in restricted markets may not be the best criteria of value, particularly when other evidence shows that the property would sell at a higher price under different circumstances. McGuire v. Commissioner, 44 T.C. 801, 808-809 (1965).

In the case at hand, the \$ [REDACTED] price used by [REDACTED] to value the common stock for section 382(e) purposes is the same as the trading price of the stock on the [REDACTED] as of [REDACTED], which date is [REDACTED] days prior to the effective date of the merger on [REDACTED]. [REDACTED] appears to be the appropriate date to value the [REDACTED] common stock for section 382(e) purposes since this is the date immediately after the ownership change. See Treas. Reg. § 1.382-9(j)(1). As summarized above, Counsel has reviewed [REDACTED]'s responses to IDR 15 regarding the reasons they did not use the \$ [REDACTED] valuation or the \$ [REDACTED] prices in the section 382(e) computation. Counsel believes that [REDACTED]'s responses are reasonable, that absent additional information that these lower unit prices accurately reflect the fair market value of the stock on [REDACTED], it would be inappropriate for the Service to use these values for purposes of proposing an adjustment to [REDACTED]'s Section 382 Limitation.

Counsel noted in your memorandum that there are several factors which might support discounting the value of the [REDACTED] common stock. For instance, [REDACTED] owned approximately [REDACTED] % of the common stock prior to the merger (See page [REDACTED]). However, in order to determine if any discounts to the publicly traded price were appropriate, it would necessary to obtain the assistance of an expert. Without expert testimony supporting a discount, Counsel does not recommend proposing an adjustment to the \$ [REDACTED] value.

Consistent with the above advice, for purposes of computing

the cancellation of indebtedness income under I.R.C. §108(b) and the corresponding reduction in tax attributes, absent additional information, Counsel believes that the \$ [REDACTED] value for the [REDACTED] common stock and the \$ [REDACTED]²⁰ value for the [REDACTED] stock are the appropriate value to be used for the computation. Again, based on the [REDACTED]'s responses to IDR 15, Counsel does not believe that the lower values (i.e., the "assumed values") disclosed in the [REDACTED] [REDACTED], without more, provide a sufficient basis to propose an adjustment based on these lower "assumed" values.

II. ADDITION INFORMATION IS REQUIRED TO DETERMINE WHETHER THE [REDACTED] [REDACTED] PREFERRED STOCK SHOULD BE EXCLUDED FROM THE SECTION 382(e) COMPUTATION.

In computing its Section 382 Limitation, [REDACTED] included in the computation [REDACTED] shares of Preferred Stock valued at \$ [REDACTED]. As summarized above, the Preferred Stock was issued on [REDACTED] into a liquidating trust for the benefit of the [REDACTED] creditors with the expectation that the Preferred Stock would be redeemed with the proceeds expected to be received from the \$ [REDACTED] [REDACTED] FTC Refunds. Counsel's advice has been requested as to whether this Preferred Stock is properly included in the Section 382(e) computation. It is Counsel's understanding that the value of the Preferred Stock is not in dispute; rather, the dispute is concerned only with the issue of whether the Preferred Stock is included or excluded from the Section 382(e) computation.

Under the stock value test, the term "stock" is broadly defined to include section 1504(a)(4) preferred stock and all stock which is treated as "non-stock" under § 1.382-2T(f)(18)(ii). Treas. Reg. § 1.382-9(k)(i). The only interest that is excluded under the stock value test is "non-stock" that is treated as stock under 1.382-2T(f)(18)(iii)²¹. Treas. Reg. § 1.382-9(k)(1)(ii). Based on this broad definition of "stock" and considering the characteristics of the [REDACTED] Preferred Stock previously summarized, it would appear that the [REDACTED] Preferred Stock would qualify as "stock" for purposes of the stock value test²².

²⁰For purposes of this advice, it is assumed that this price reflects the FMV of the stock on or about [REDACTED].

²¹"Non-stock" may be treated as stock under this regulation in order to increase the percentage of ownership change above the 50% threshold for imposition of the § 382 Limitations.

²²On [REDACTED], [REDACTED] acknowledge that the Preferred Stock may not be treated as stock

Despite the broad definition of "stock" for section 382(e) purposes, section 382(l)(6) does not permit all types of "stock" to be included in the section 382(e) computation. Rather, the section 382(e) computation reflects only that "increase (if any) in value of the old loss corporation resulting from the surrender or cancellation of creditors claims in the transaction." I.R.C. § 382(l)(6). To the extent that the increase in value of the loss corporation derives from sources other than "the surrender or cancellation of creditors claims," the increase shall not be included in the section 382(e) computation. For example, any increase that is attributable to an infusion of fresh capital rather than from the conversion of debt into stock will not increase the value of the loss corporation. See Notice of Proposed Rulemaking, RIN 1545-AQ60, 57 FR 34736 (August 6, 1992)²³. In addition, stock issued to creditors in surrender or cancellation of their debt which does not increase the value of the loss corporation would not, under section 382(l)(6), be included in the

for federal tax purposes. This section of the disclosure statement discusses the potential federal tax consequences to the prospective participants in the Plan. Included in this section is a discussion of the potential tax treatment of the Preferred Stock in the event that the "

" Despite this disclosure, Counsel believes that, based on the stated rights of the Preferred Stock holders, it would be difficult to advance an argument that the Preferred Stock is not "stock" for section 382(e) purposes.

²³"As originally enacted in the 1986 Act [Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2085, section 621)], section 382(l)(6) provided that if section 382(l)(5) did not apply to any exchange of debt for stock in a Title 11 case, the value of the loss corporation under section 382(e) was the value of the loss corporation immediately after the ownership change. The 1988 Act [The Technical and Miscellaneous Revenue Act of 1988 ("1988 Act") (Pub. L. 100-647; 102 Stat. 3393, 3656 and 3683, sections 1006, 4012 and 5077)] amended section 382(l)(6) to provide that, in the requisite circumstances, the value of the loss corporation under section 382(e) is increased to reflect the increase (if any) in value of the loss corporation resulting from any surrender or cancellation of creditor's claims in the transaction....The purpose of the 1988 Act amendment is to allow an increase in the value of the loss corporation's stock under section 382(l)(6) to the extent attributable to a conversion of debt into stock, but to deny an increase in such value attributable to the infusion of fresh capital."

computation of the loss corporation under section 382(e).

1. Additional information is needed to ascertain whether the issuance of the [REDACTED] Preferred Stock resulted in an increase in value of the loss corporation.

In the instant case, the facts do not demonstrate that the issuance of the Preferred Stock resulted in an increase in value of the loss corporation. Although the [REDACTED] creditors surrender their debt for stock, [REDACTED] (as well as [REDACTED] appears to be substantially in the same financial position both before and after the debt for stock exchange. For example, prior to the debt for stock exchange, [REDACTED] had a FTC Refund receivable of \$ [REDACTED] and a liability to the Class [REDACTED] creditors of an unknown amount (presumably at least \$ [REDACTED]). Following the debt for stock exchange, [REDACTED] had a FTC Refund receivable of \$ [REDACTED]²⁴ and Preferred Stock with a book value of \$ [REDACTED]. After the redemption of the Preferred Stock on [REDACTED] the FTC Refund receivable was \$ [REDACTED] and the Preferred Stock was canceled for the same amount²⁵. For all practical purposes, this debt for stock exchange is no different from the transaction where [REDACTED] satisfied certain creditors claims by giving the creditors the [REDACTED] Note Receivable and the [REDACTED] Stock; in both situations, [REDACTED] gave up an asset to satisfy a debt. The only real difference between the debt for asset exchanges and the debt for preferred stock exchange is the timing of the exchanges; [REDACTED] could not extinguish the later claim until the FTC Refund was received.

Absent additional information, it is difficult to ascertain how the issuance of the Preferred Stock resulted in any real increase in the value of the loss corporation. However, Counsel recommends that you issue an IDR to [REDACTED] to ascertain its position on how the debt for Preferred Stock exchange resulted in an increase in the value of the loss corporation as required by

²⁴According to [REDACTED] of [REDACTED]'s [REDACTED] and [REDACTED] 10-Ks, the anticipated FTC Refund of \$ [REDACTED] was reflected on [REDACTED]'s balance sheet at [REDACTED] and [REDACTED].

²⁵According to the terms of the [REDACTED], the amount the Preferred Stock holders would receive was directly related to the amount of the FTC Refund (not to exceed \$ [REDACTED]). If the amount of the FTC Refund was substantially less than anticipated, the cost to redeem the Preferred Stock effectively decreased by the same amount. Thus, to the extent that there was any real contingency in receiving the FTC Refund, there appears to be a corresponding contingency to the amount required to redeem the Preferred Stock.

I.R.C. § 382(1)(6). As part of this request, Counsel recommends that you obtain information regarding the amount of the Class █████ debt, and the amount of the effective recovery of these creditors. In addition, Counsel suggest that you request the administrative files from the Service Center for the FCT Refund claim for purposes of ascertaining at the time of the merger (a) █████'s knowledge of the status of the claim and (b) whether there was any real contingencies associated with the claim. Once you have received this information, please contact Counsel so that we may review and discuss the information received.

2. Additional information is required to ascertain whether there was any purpose, other than increasing the Section 382 Limitation, for structuring the debt for preferred stock exchange in the manner is was structured.

An anti-abuse provision applicable to the stock test allows the IRS to question the inclusion of any stock that it considers to be a sham. The anti-abuse rules of Treas. Reg. § 1.382-9(k)(6)(i) were designed to prevent the deliberate artificial increases in the value of the loss corporation attributable to stock that is not subject to risks of corporate business operations. Under the regulation, the amount determined under the stock value test is reduced by "the value of stock that is issued as part of the plan one of the principal purposes of which is to increase the § 382 limitation without subjecting the investment to the entrepreneurial risks of corporate business operations."

As summarized in II.1. above, there does not appear to be any apparent difference (aside from the Section 382 Limitation impact) in the debt for preferred stock exchange compared to the debt for █████ Note exchange or the debt for █████ Stock exchange. However, information must be obtained to ascertain why these transactions were structured differently.

Counsel requests that you issue an IDR to █████ to inquire (1) the business purpose, if any, for structuring the debt for preferred stock exchange as it was structured, and (2) why the transaction was structured different than the █████ Note and █████ stock exchanges. The IDR should also inquire as to whether there was any benefit to the creditors in structuring the transaction in this manner. The IDR should also request information as to whether any financial and/or legal advice was sought with respect to this transaction, who the advise was requested from, the date of the advice, and whether any written advice was obtained. If written advice was obtained, a copy of the written advice should be requested. Once you obtain a response to the IDR, please contact Counsel so that we may review and discuss the information received.

CONCLUSION

As indicated above, additional information is needed to ascertain whether the Preferred Stock is properly included in the section 382(3) computation. Please contact the undersigned should you need further assistance with the IDR requests.

In reviewing the Section 382 Limitation, Counsel noted that [REDACTED] increased the value by \$ [REDACTED] which amount represents the cash paid to the [REDACTED] creditors. Based on our review of the section 382(1)(6) regulations, it does not appear that this amount should be included under the stock value test. Please contact Counsel so that we may further discuss this issue.

Should you have any questions in this matter, please contact the undersigned at (206) 220-5954.

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